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February 14, 1992

Honorable Bradley L. Jacobs
Orange County Assessor
630 North Broadway
P.O. Box 149
Santa Ana, CA 92702

Attn:

Re: HUD 236 Properties

Dear Mr. Jacobs:

In your letter of January 6, 1992 you asked for our opinion on several questions involving the interrelationship between Property Tax Rules 4 and 8, Revenue and Taxation Code, sections 110 and 402.1 and Prudential Insurance Company of America v. City and County of San Francisco (1987) 191 Cal. App. 3d 1142 in relation to the assessment of a Section 236 housing project.

First, when no reliable market data is available, may Rule 4 be disregarded and Rule 8 applied? By its own terms Rule 4 is to be used "when reliable market data are available with respect to a given real property." Similarly Rule 8 "is the preferred approach for the appraisal of land when reliable sales data for comparable properties are not available." So given the condition of "no reliable market data", it is clear that Rule 8 would have preference over Rule 4.

This conclusion would be particularly applicable to Section 236 projects because only the same such projects can be used as examples of comparable sales.

In 59 Ops. Cal. Atty. Gen. 293 the California Attorney General has concluded that:

> The rental limitations and other limitations and other restrictions contained in the contract between the Federal Government and the owner of a 236 project are use restrictions within the meaning of Section 402.1 of the Revenue and Taxation Code.

And in Jones v. Los Angeles County (1981) 114 Cal. App. 3d 999 the court of appeal has held that comparable properties must be subject to the same limitation on use as the property to be

assessed. Under these restrictions it would appear that sales of comparable 236 projects would be severely limited.

Further, if Rule 8 is used, does a cash equivalency analysis and/or an adjustment have to be executed? Yes, but only within the context of the methodology of Rule 8, per se. Since Revenue and Taxation Code, Section 110(a) defines "fair market value" as the amount of cash or its "equivalent" that the sale of the property would bring, it is always necessary to convert non-cash items to their equivalents. This is accomplished in Rule 8(g)(1) and (2) by insuring that the capitalization rate is developed from current economic data that takes cash equivalents into consideration.

In reference to Rule 4 and the Prudential case, must a cash equivalent adjustment be done if the Comparable Sales Approach is not used? In Prudential the buyer purchased a hotel for $69 million cash and assumed a loan for $16 million for 12 1/2 years at 8 percent interest. The market interest for loans of this type was between 12 and 13 percent. When discounted to market the cash equivalent of the loan was $11.8 million. The assessor refused to adjust for the cash equivalent primarily because the loan was only 18.8 percent of the sale price whereas usually the loan greatly exceeds the amount paid in cash. In construing the application of the rule the court of appeal held, where a buyer assumes a loan from a seller at an interest rate different from the going market rate, Rule 4 requires that a cash-equivalent adjustment be made. So it is clear that the Prudential decision controls only those appraisals that are based on the application of Rule 4 when the seller doesn't receive the entire purchase price in cash.

May I use Rule 8 and still comply with Section 110 and its inherent cash equivalency directive? Yes, by carefully following the methodology specified in Rule 8(c) and (g) you will insure that the amount to be capitalized and the capitalization rate is in accord with the current economic market. This is where by analogy you correct for the Prudential problem where the loan rate was not at market.

Our intention is to provide timely, courteous and helpful responses to inquiries such as yours. Suggestions that help us to accomplish this goal are appreciated.

Very truly yours,

James M. Williams

James M. Williams
Senior Tax Counsel

JMW:jd/4357H

cc: Mr. John W. Hagerty
Mr. Verne Walton

State of California

Board of Equalization
Legal Division

Memorandum

To: Mr. Richard Johnson
Mr. Mark Nisson

Date: July 17, 1998

From: Kristine Cazadd
K. Cazadd

Subject: Valuation of Low Income Housing Projects

This is in response to your June 29, 1998 request for research and analysis of the legal issues pertaining to the valuation of low income housing. Please see the following in regard to answering the specific questions to be addressed. We recommend that a new letter to assessors be issued on this topic.

1. What are the legal parameters of the 515 program and the 236 projects under the federal law and should they be treated the same for property tax valuation purposes.

The low income housing programs constituting the subject of this inquiry were originally enacted and amended by the U.S. Congress at different time periods and under different enforcing agencies. The program characterized as "Section 235 and 236" housing was created under the 1968 National Housing Act as a means of providing government support, financing, insurance, accelerated depreciation, and preferred returns on equity to private corporations/entities, quasi-governmental agencies, and nonprofit organizations which construct and operate low income housing projects. The Department of Housing and Urban Development (HUD) is the supervising agency, with local housing authorities also having substantial power to determine the location, design, selection of contractor, and other matters pertaining to the development of these housing projects.

The program characterized as "Section 515" housing was created under the Housing Act of 1949 as a means of providing government support, financing, insurance, accelerated depreciation, low cost loans, and other benefits to private developers, quasi-governmental agencies, and organizations which construct low income housing under urban renewal and to fill the post-war housing shortage. The Farmer's Home Administration is the overseeing agency.

Regardless of origin or of the oversight agency however, the determination of whether the owners of these and other low income housing projects will receive any available tax credits, benefits, and incentives is now made by the Internal Revenue Service. In revamping the system and repealing former tax shelter and deduction provisions in 1986, Congress brought all low income housing projects under Section 42 of the Internal Revenue Code as part of the Tax Reform Act of 1986. The purpose of this section was to give private equity investors valuable

tax incentives in return for spending their money to build the needed amount of low income rental housing units in specific locations and to operate such housing units for a long enough time period, e.g. 15 years, the "compliance period." The tax credit system established in Section 42, authorizing low income housing credit ("LIHC") is the sole method adopted by Congress to accomplish this objective. Since that time, the IRS has authority to qualify (or to deny) numerous types of housing programs under Section 42, in addition to those mentioned above. Some of these are Section 8 and Section 221(d) HUD programs and Section 502(c) FmHA programs.

Thus, the main issue, for property tax valuation purposes, is not so much the type of housing project, but whether and to what extent the project being appraised qualifies for the LIHC under Internal Revenue Code Section 42. The availability and amount of LIHC is the foundation for encouraging investors to participate in these projects, because it is specifically designed to compensate the investors for receiving little or no cash flow due to reduced rents from low income tenants for the 15-year period. Under IRC Section 38, a credit (LIHC) against the taxpayer's net income tax shall be allowed for his/her investment in low income housing under Section 42(a). As such, LIHC is the basis for calculating the internal rate of return for the investors in any given project.

The following discussion summarizes the parameters of LIHC and its effect on the value of a project in detail.

2. What is the criteria for and extent of LIHC for qualified low income housing projects under IRC Section 42?

a. Basic summary of criteria for and extent of LIHC.

As enacted, the amount of LIHC for any qualified low income building in a taxable year in the credit period is an amount equal to the applicable percentage of each qualified low income building. This applicable percentage is generally 70 percent value credit for new buildings and 30 percent value credit for certain older buildings, unless substantially rehabilitated. The tax credits (LIHC), taken over a period of 10 years (the 10-year credit period) are available only for buildings that retain their low income status for a minimum of 15 years (the 15-year compliance period). Although numerous modifications to certain aspects of the LIHC system have occurred, the Revenue Reconciliation Act of 1993 permanently extended LIHC indefinitely.

b. Projects and Buildings which qualify.

LIHC is available only to owners of a "qualified low income housing project" or a "qualified low income building." A "qualified low income housing project" is one which is "residential

rental property" (as defined in IRC Section 103), some or all of which meets the low income set-aside requirements under IRC Section 42 (g)(1). Unlike projects or buildings financed with tax exempt rental housing bonds, a "qualified low income housing project" may include numerous buildings, residential hotels (even though dining and other activities are included), and projects with functionally related and subordinate facilities (recreational, parking and laundry facilities) as long as no fees are charged, or fees are refunded to the residents at the end of their lease.

A "qualified low income building" is one which during the 15 year compliance period is part of a "qualified low income housing project" and is subject to the depreciation schedules under IRC Section 42(c)(2), (usually the 27.5 year straight line schedule). A "qualified low income building" may include an apartment building, a single-family dwelling, a townhouse, rowhouse, duplex, manufactured housing affixed to real property, or a condominium. It does not include projects or buildings receiving assistance under Section 8 (e)(2) of the Housing Act of 1937, or under the Homeless Assistance Act of 1988, or benefits under a cooperative housing or tenant stockholder corporation.

c. Low Income and Rent Restriction Requirements.

IRC Section 42 establishes that a minimum number of units are (i) rent restricted and (ii) occupied by low income tenants during the 15 year compliance period. Thus, in order for a low income housing project to qualify for LIHC, one of two tests must be met. First, at least 20 percent of the project must be occupied by households with incomes at or below 50 percent of the area median income; or, secondly, at least 40 percent of the project must be occupied by households at or below 60 percent of area median income. It is important to note that rents paid by tenants in low income units are restricted to 30 percent of the qualifying tenant income (i.e., 50 - 60 percent of the area median income) including utilities.[1]

A housing unit is considered "low income" if: (1) occupied by tenants with incomes meeting designated income requirements (at or below 50 - 60 percent of the area median income; (2) its rent is restricted; (3) the unit is suitable for occupancy; (4) the unit is not used on a transient basis (less than 6 months); and (5) the occupants are not all students. The income limit established by HUD and approved by the IRS for a given period must be met at the time the low income housing project or building is placed in service. Thus, a decline in the are median gross income after the date the limit is established will not require a further reduction in rent.

In regard to the rent restrictions, the gross rent paid by the tenants in the low income units may not exceed 30 percent of the qualifying income standard applicable to that project or building (i.e., 50-60 percent of the area median income). To provide project owners with certainty that the rent will be received, IRC Section 42 (g)(2)(C) provides that the rent restriction is based on

[1] IRC Section 42 (g)(2).

the number of bedrooms, rather than the number of persons, occupying the unit and the imputed income limit applicable to that unit (with respect to the LIHC credit allocated).

Each state is assigned a limited amount of LIHC for allocation among housing projects. State and local housing credit agencies are authorized to allocate credits for that state, and only to projects where the housing owner commits to providing long-term, low income housing. In California, the amount of credit allocated to any housing owner must be authorized by the California Tax Credit Allocation Committee, and is based on the project's need for the credit in order to be economically feasible. Except for projects or buildings financed with certain tax-exempt bonds, numerous types of low income housing projects may qualify, but only those with allocated credit under Section 42 are entitled to LIHC.[2] Buildings not eligible to receive credit allocations after 1989, may qualify however, if an "extended low income housing commitment" (in the form of an agreement) is executed between the taxpayer and the allocating agency. The agreement/commitment sets forth the compliance requirements (discussed below) and is binding on all successors (potential buyers).

d. Determining the building's LIHC - "Eligible basis of building costs" and "Qualified basis attributable to low income units."

The availability and size calculation of the LIHC is extremely important, because it determines the equity investment that can be raised for a given project. The predominant benefit to the investor in such projects is the tax savings resulting from the credit itself. Since investors will rarely receive any cash flow, the LIHC and some tax losses are the sole components of the investors' return of or on his investment, i.e., his yield. LIHC is calculated on the following three factors: (1) the "eligible basis" of building acquisition or construction costs; (2) the "qualified basis" attributable to the low income units, and (3) the annual LIHC based on the qualified basis and applicable credit percentage, together with the LIHC proration during the first year of the credit period.

(1) Eligible Basis: The "eligible basis" of a newly constructed building or of an existing building that is "substantially rehabilitated" is its adjusted basis attributable to acquisition, rehabilitation, or construction costs for the entire building (not merely the low income units). Its adjusted basis reflects the costs before first-year depreciation of the building, (usually at the end of the first taxable year of the 10-year credit period). For *existing* buildings allocated credits after 1989, the eligible basis is zero, except in certain situations where, for example, the building is substantially rehabilitated, or is acquired by purchase, or was not previously placed in service during the past 10 years. For *new or substantially rehabilitated* buildings after 1989, the LIHC eligible basis is 100 percent of the cost.[3] An added tax benefit is that the

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[2] See IRC Sec. 42(h)(6) and (h)(4).

[3] There is an exception under IRC Section 42(f)(5)(B) for certain acquisitions of older, federally assisted buildings not substantially rehabilitated.

eligible basis for *new buildings in "high cost areas"* (designated by HUD as "difficult development areas") may be increased by 30 percent, that is up to 130 percent of the building's cost.

The eligible basis of a building must be reduced however, by the amount of any federal grants made to a project within the 15-year compliance period. Similarly, the eligible basis is reduced by an amount equal to the outstanding balance of any federally subsidized loans ("interest subsidies" per Section 402.9) related to construction or rehabilitation, if the project owner wishes to take the 70 percent present-value LIHC. Thus, once the "eligible basis" of a building is established, it cannot increase, but it may decrease if such federal grants or loans are received. The owner's remedy is to elect to reduce the building's eligible basis by the amount of the federal subsidy and use the higher applicable percentage for the remainder of the eligible basis. [4]

(2) Qualified Basis: The qualified basis of a building is the fraction of the building's eligible basis that is "attributable to the low income units." The qualified basis is then multiplied by the applicable LIHC percentage, in order to calculate the LIHC amount each year. [5]

The qualified basis calculation is based on the lesser of (i) the "unit fraction," which is the ratio of the number of the occupied low income units divided by the total, or (ii) the "floor space fraction," which is the ratio of the floor space of the occupied low income units to the total floor space of the rental units in the building. As noted above, a "low income unit" is any rent-restricted unit occupied by tenants meeting the income limitation for that unit.[6] As an example, if the eligible basis of a building's cost is $200,000, and 50 percent of the units are occupied by low income tenants, and the floor space of these low income units is 45 percent of the total floor space for all units, the "qualified basis" is $90,000 (which is the lesser of 50 percent or 45 percent, times the eligible basis).

While the "qualified basis" is based on the units actually occupied by low income tenants in the first taxable year that the building is placed in service (usually on the last day of the first year), it must be maintained continuously during the 15-year compliance period in order for the LIHC to be allocated over the full 10-year period. The "qualified basis" in the building may be increased in subsequent years, if additional units become low income occupied, or if the floor space of low income units is increased. When such increase occurs, the LIHC is claimed for the added qualified basis at a different rate.[7]

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[4] See IRC Section 42 (i)(2).
[5] IRC Section 42(a).
[6] IRC Section 42 (i)(3)(B)(ii).
[7] IRC Section 42 (f)(3)(A)(i).

(3) Annual LIHC based on the qualified basis and applicable credit percentage, with the LIHC proration in the first year claimed.

The actual amount of LIHC is calculated by multiplying the qualified basis attributable to the low income units in a building by the applicable LIHC "credit percentage" allocated to the building (through the authorized credit agency). For buildings placed in service in 1987, the maximum credit percentage is either 9 percent annually for 10 years (i.e., total LIHC of 90 percent over 10 years), or 4 percent annually for 10 years (i.e., 40 percent over 10 years). The 9 percent LIHC is available for new construction and substantial rehabilitation costs, while the 4 percent is available only for building acquisition and substantial rehabilitation costs.

For post-1987 buildings, the 9 percent (for new construction and substantial rehabilitation) and 4 percent (building acquisition and substantial rehabilitation) annual LIHC credits are adjusted so that the present value of the credits taken over 10 years equals 70 percent and 30 percent respectively. Similarly, for buildings placed in service after 1989, the 70 percent present- value credit is available for new construction and substantial rehabilitation costs allocable to 1 or more low income units which meet the requirements, and the 30 percent is available for building acquisition and substantial rehabilitation costs within the criteria.

The amount of LIHC in the first year claimed is based on the number of months the low income units are occupied. This first-year proration also applies to LIHC for the qualified basis added after the first year. Any unused portion of the first year's credit for the additional qualified basis may not be recovered subsequently.

e. Disallowance of the Credit.

There are several limitations on the allowance, timing and amount of LIHC allocated to and useable by every project.

(A) During the first year, any LIHC is disallowed (and must be adjusted) for any months that the low income units were not occupied.

(B) No LIHC is allowed if the owner of a qualified project does not have an allocation from, or a binding commitment with, the state's housing credit agency. Once the credit is so authorized, the LIHC for that project is limited to the amount allocated. There is a special exception for owners of projects where at least 50 percent of the land and building is financed by tax-exempt bonds, in which case an allocation of LIHC may be made by the supervising federal agency.

(C) LIHC may be claimed only during the 10-year credit period designated for that project, beginning with the first year the building is placed in service or in the second year, if the owner has made the election to do so.[8]

(D) Noncompliance with the 15- year compliance period occurs because low income occupancy is not maintained continuously throughout this period (starting at the beginning of the first year of the LIHC credit period). Noncompliance means low income units are rented to non-low income tenants. Noncompliance triggers a recapture of the LIHC, discussed below.

d. The Recapture of LIHC and Penalties.

As previously noted, the qualified basis for LIHC must be maintained throughout the 15-year compliance period, beginning on the first taxable year in which the LIHC is claimed, even though the LIHC is taken over a 10-year period (referred to as the "accelerated portion" of the LIHC). If a compliance failure occurs during the 15-year period, it triggers recapture of the accelerated portion of the LIHC during the 10-year period. When recapture is triggered, no LIHC is allowed for that year. Thus, the owner must pay recapture on the disallowed LIHC and accrued interest, which is not deductible.

Some of the events which trigger non-compliance and recapture are: (i) failure to rent qualified low income units to low income tenants; (ii) a complete or partial change in ownership within the 15-year compliance period, unless the seller posts a bond satisfactory to the IRS (usually equivalent to the total credits claimed by the owner) and produces evidence that the building will meet the low income occupancy requirements for the remainder of the period; (iii) a federal subsidy is used to refinance the building; and (iv) failure to restore or reconstruct within a reasonable time, any portion of the building damaged or destroyed by a casualty loss. In virtually all cases, the owners take every step necessary to avoid recapture of any LIHC, including in change in ownership transactions posting the necessary bond and insuring that the new owner will receive the same qualified basis, LIHC percentages, and remaining compliance period as the original owner.

3. To what degree does LIHC have an effect on the valuation of the property?

a. Value of the Tax Credits.

As discussed above, Congress was fully aware of the fact that the low rents needed to achieve the targeting level of the low income tenants would not be able to support the full amount of

[8] LIHC is claimed by the owners filing Form 8586 (Low Income Housing Credit). The annual statement filed with the IRS (in addition to the owners tax return) is Form 8609 (Low Income Housing Credit Allocation Certification), which is used to obtain the housing credit allocation.

the mortgage financing and construction costs. Thus, the primary purpose of the tax credit system in IRC Section 42 was to make the LIHC "sufficiently generous to offset the effect of these low rents".[9] Although no credit is allowed on the land, the amount of allocated LIHC on the building directly relates to the rate of return or yield that the investors expect to receive for their investment in the building and its operation.

The amount that a willing buyer would pay for such a project depends in large part on the credit itself. The rate of return for the investor in a low income project is composed of three major items: (a) the LIHC, (b) any cash flow from the operation and/or sale of the project, and (c) the tax benefit (cost) of taxable losses (income).[10] Since the major tax benefit is the LIHC, projects which have received less credits, will produce less in investor yields. For example, in projects constructed or operated with proceeds from a tax exempt bond, less than half of the tax credits are allocated than in projects built with taxable bonds. Unless tax losses related to that low-credit project are increased, the yield to investors will be reduced, thereby reducing the attractiveness and value of the project in the marketplace. A popular way of increasing the tax credits available for a tax-exempt bond project is to utilize the building rehabilitation credit (IRC Section 47 - tax credits for costs of restoring or rehabilitating historic buildings) and the low income housing credit (LIHC) in tandem, in which case the net tax benefits achievable by combining the two can exceed the benefits of using either alone. As an example showing the value of the credits taken together and taken individually, see the attached appendix A.

b. Application of Revenue and Taxation Code Sections 402.1 and 402.9 to Projects with Allocated LIHC.

In previous letters to assessors the Board staff has advised that pursuant to the relevant Revenue and Taxation Code provisions above, low income housing projects financed under (HUD) Section 236 of the National Housing Act are (1) restricted properties within the meaning of Section 402.1 and should be valued as such, (2) that the income approach is the preferred valuation approach for these properties, and (3) the band-of-investment method is the appropriate method for deriving the capitalization rate. Beginning in September 1979, assessors were advised of legislation codified in Section 402.9 stating that in determining the income to be capitalized when valuing these properties, "the assessor shall not consider as income any interest subsidy payments made to a lender by the Federal government" for financing such projects (in the form of low cost loans).[11]

Recently, the First District Court of Appeal issued a decision in *Mission Housing Development Company v. City and County of San Francisco* (1997), 59 Cal.App.4th 55, stating in part that

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[9] "Tax Management Multistate Tax," Portfolio No. 477, p.A-27.

[10] "The Tax Magazine," July 1997, *Cost Segregation Studies Improve Investor Yields in Low Income Housing Tax Credit Projects*, Michael J. Novogradac, CPA.

[11] Letter to Assessors No. 79/37, p. 1.

the assessor's reliance on the band-of-investment method for deriving the applicable capitalization rate is proper, and that the inclusion or exclusion of interest subsidies (per Section 402.9) is entirely irrelevant when using this method. At issue in the valuation aspect of the case were the two different methods of deriving the capitalization rate under Rule 8 (g) in regard to the valuation of several "Section 236" low income housing projects financed in part by low interest loans from HUD.

The project owners (taxpayers) sought to prove that the band-of-investment method was arbitrary and violated standards prescribed by law. In this regard, taxpayers contended that the assessor (1) failed to discount assumed mortgages to their cash equivalents, and (2) erred in determining the applicable capitalization rate. Responding to the first contention, the court held that Rule 4, in requiring the use of the comparable sales approach, is not applicable when the assessor is using the band-of-investment method governed by Rule 8, since Rule 8 does not require discounting mortgages to cash equivalents. As to the second contention, the court held that the requirement under Section 402.9, to convert to a cash equivalent any interest subsidies and exclude that amount from the income stream, is also not applicable, since it is only relevant where the comparable sales method is used to derive the cap rate. In the words of the court,

> "Taxpayers' argument again assumes the use of the comparable sales method of deriving the capitalization rate. We have already concluded, however, that the assessor properly used the band-of-investment method to calculate the applicable capitalization rate. As we explained previously, under this method, the capitalization rate is derived by using a weighted average of the debt and equity for comparable properties. The inclusion or exclusion of interest subsidies and the proper valuation of mortgages is entirely irrelevant to this method." (p. 87)

Thus, even though the court never addressed the issue of low income housing credits (LIHC), it clarified the very narrow application of section 402.9 to 236 housing projects only, and to strict construction of the language in the statute.

Based on the foregoing case law and on the 1986 the adoption by Congress of the LIHC provisions in IRC Section 42 together with the repeal of the previous (i) accelerated depreciation, (ii) the 5-year amortization of rehabilitation expenses under IRC Section 167(k), and (iii) the expensing of interest and taxes, and (iv) the availability and benefits received from various deductions, the following conclusions may be drawn:

- First, Section 402.9 is not applicable to projects valued under Rule 8 and the band-of-investment method of deriving the capitalization rate. Cash equivalency is relevant only to the comparable sales approach in Rule 4.

- Secondly, Section 402.9 is not applicable to projects with allocated LIHC under IRC Section 42 for the following reasons:

(a) It was adopted in 1978, long before Congress passed the tax credit system (LIHC) consolidated in IRC Section 42 with the repeal the earlier tax incentive provisions in 1986;

(b) As discussed in some detail above, LIHC is not an "interest subsidy payment" described under 402.9, but is the major component in present worthing the income stream of all low income housing projects;

(c) In applying the income method (the preferred method of valuation for these properties) under Rule 8(g), the band-of-investment method is proper for determining the cap rate, since it is the same method by which the investors in low income housing projects with LIHC calculate their rate of return.[12] Accordingly, the assessor should establish the present worth of the future income stream of a housing project which is allocated LIHC, by considering (among other factors) both the rental income at its restricted rate (pursuant to the authority of Section 402.1), as well as the amount of the LIHC allocated to the project. The reality of the credit system for low income housing projects under IRC Section 42 is that the anticipation of income from such projects in the marketplace is based on these two factors (the primary one being the LIHC);

- Thirdly. Section 402.9 is applicable only to 236 projects without allocated LIHC and in a manner consistent with our previous Letters to Assessors and the *Mission Housing* case;

- Fourthly, Rule 8 requires and section 402.9 does not preclude the capitalization of all net benefits of all types of low income housing projects, including the benefits of LIHC.

Given the recent questions received from various assessors and the changes in the law, revised advice based on these conclusions would be appropriate.

KEC:ba
Attachments:

cc: Mr. Larry Augusta

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[12] Ibid., "The Tax Magazine."

APPENDIX

Valuation of Older Low Income Housing Projects

Example: Taxpayer purchases an older structure which qualifies for the 20% rehabilitation credit for $2,000,000, of which $200,000 is allocable to the land. Taxpayer thereupon expends $3,000,000 on qualified rehabilitation expenditures, converting the building into an apartment project, and claims the 20% rehab credit. In addition, Taxpayer rents 40% of the project to low-income tenants, as defined for purposes of the low-income housing credit, and otherwise qualifies the project for the low-income housing credit.

The annual tax benefits for which the project with both rehabilitation credit and low-income housing credits are as follows:

Amount of One-Time Credit:		
Rehabilitation Credit:		
($3,000,000 x 20%)		$600,000
Amount of Annual Credit:		
Low-Income Housing Credit Acquisition:		
$1,800,000 x 40% x 4%	$ 28,800	
Rehabilitation:		
$3,000,000 - 600,000 =		
$2,400,000 x 40% x 9%	86,400	
Total Annual Credit	$115,200/yr.*	
Amount of Annual Depreciation Benefit:		
$4,800,000 - 600,000 =		
$4,200,000 ÷ 27,5 x 28%	$ 42,764/yr.	
Total Annual Benefit		$157,964

If, the annual tax benefit on same project of which only low income housing applies is as follows::

Amount of Annual Credit:	
Acquisition:	
$1,800,000 x 40% x 4%	$ 28,800
Rehabilitation:	
$3,000,000 x 40% x 9%	108,000
Total Annual Credit	$136,800/yr.

Amount of Annual Depreciation Benefit:		
$4,800,000 ÷ 27.5 x 28%	$ 48.8743	
Total Annual Benefit		$185.673

Thus, the cost to Taxpayer of claiming the rehabilitation credit was a reduction in tax benefits of $27,709 per year for 10 years. The benefit, however, of an additional first-year credit of $600,000 would more than offset the discounted present value of $27,709 in annual loss of benefits over a 10-year period.[1]

[1] "Tax Management," Portfolio No. 477, *Rehabilitation Tax Ciredit and Low-Income Housing Tax Credit, p. A-58, A-59.*